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ESTATE PLANNING & ADMINISTRATION
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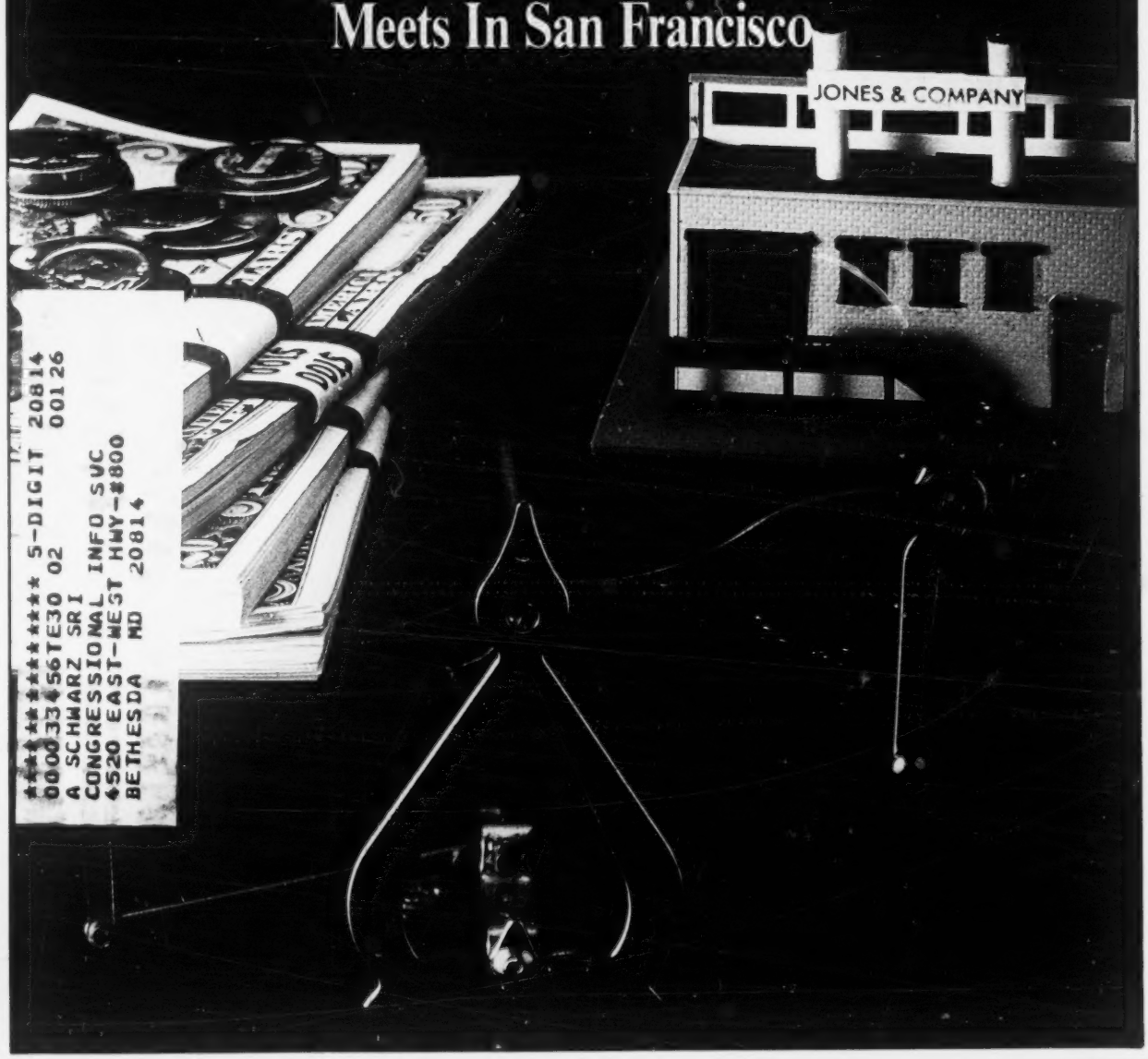
FEBRUARY 1990

Valuation: What Are Your Client's Assets Worth?

Trusts & Estates Conference Meets In San Francisco



TRUSTS & ESTATES®

Volume 129, No. 2 FEBRUARY 1990

Estate Planning and Administration Since 1904

10 **Trusts & Estates Conference Meets In San Francisco**
First annual meeting to address wide variety of estate planning topics

VALUATIONS

18 **Valuing The Family Business**
Valuation difficulties are often encountered in establishing value with limited market exposure — *Raynor J. Klaris*

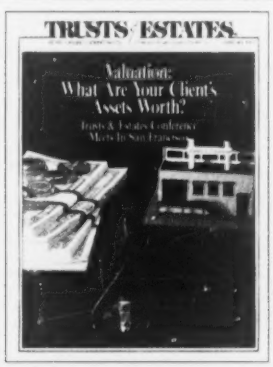
30 **Determining Fair Market Value Of Oil Interests Is An Art**
If exact information is scarce, opinions will differ widely as to what cash flow will be — *John Castleton*

35 **Keeping Up With The New "Rate Of The Month" Tables**
New IRC Sec. 7520 results in an entirely new system for valuing life estates and similar interests — *Jerry J. McCoy*

40 **ESOPs Are Becoming Popular Corporate Financial Tools**
More corporations are forming ESOPs for corporate financial use rather than employee benefit use — *James Brockardt, Robert Reilly*

44 **Understanding The Principles Involved In Partnerships**
Trustees need to become familiar with the obstacles to realizing maximum value — *Jeb Brooks, Nicholas T. Rhinelander*

49 **New Study Seeks Successful Strategies For The 90's**
Study identifies the state of the trust industry current trends and ways to excel in the future — *Mary M. Miller*



COVER

Determining what a client's assets are worth in a free and open market takes both skill and creativity on the part of the estate planner. Photo By Jos. Palmieri, Augusta, NJ.

DEPARTMENTS

4 Commentary
6 Trends & Developments
56 Law & Life Insurance
59 Meetings

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BPA

Commentary

An Opportunity For a Liberal Education In Estate Planning

When I was in high school, an inspirational teacher told me that to achieve a liberal education you had to know a little about everything and a lot about one thing in particular. With that in mind, it is our pleasure this month at TRUSTS & ESTATES to offer you an opportunity for a liberal education in estate planning and administration.

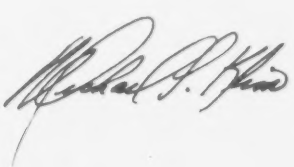
The one thing in particular on which we will concentrate this month is valuations. This month's features discuss practical techniques and approaches for valuing closely held business interests, small oil and gas interests, partnership interests, and issues related to employee stock option plans.

In addition, there is a review of the new IRC Sec. 7520, which calls for redetermination of the applicable interest rates every month resulting in an entirely new system for valuing life estates, remainders and annuities.

To fulfill the second part of the equation and learn a little about everything in this rapidly changing field, we offer you the chance to attend the 1st Annual TRUSTS & ESTATES Conference on Estate Planning, which is being held this month in San Francisco. (See details starting on page 10.) There, nationally recognized experts in the field of estate planning and administration will discuss and answer questions on Sec. 2036(c) and its impact on closely held businesses, fiduciary income taxation, the prudent investor rule, marital deduction planning for non-citizen spouses, disclaimers, S-corporation planning, malpractice and other recent developments. We will even have what promises to be a very exciting presentation on public speaking for estate planners.

Also in this month's issue, we conclude the two-part series on BEI Golembe's trust research project. This second part addresses pricing and performance.

We hope you will find this month's issue very useful and we hope to see you in San Francisco.



New Study Seeks Successful Strategies For The '90s

Study identifies the state of the trust industry today, current and anticipated trends and possible ways to excel in the coming decade

By **MARY M. MILLER**

EDITOR'S NOTE: This is the second part of a two-part report on a recently completed study entitled "Seeking Successful Strategies: Articulating An Agenda for the 1990's," which was conducted by BEI Golembe. It was conceived as a means to identify the state of the trust industry today, current and anticipated trends and strategies to succeed in the coming decade. This second part addresses pricing and performance.

Trust services are valuable because of their depth, scope and benefits. However, most trust organizations have not priced their services in accordance with their value, resulting in the offering of "priceless advice" for a very low fee.

Not only is the presentation of trust products/services confusing, current trust pricing structures and the presentation of those structures are overly complicated and too technical resulting in confusion for the client. In many trust organizations, administrators and sales persons experience difficulty in explaining the rationale for pricing structure and practice. The result for most trust organizations is client confusion.

Historical definitions of account types and use of "legalese" in both product and pricing materials have, in the past, clouded comparisons of offering service between trust and non-trust competitors. In order for trust organizations to effectively market their services, they must make pricing comprehensible, first internally, to trust and other bank employees and, then, externally, to the client.

Trust pricing should be a marketing tool. It should be comprehensive, rational, equitable and easy to articulate. Further it should reflect both the value of and risk inherent in the services. To make pricing comprehensible is to have defined the strategies and structures based on conscious decisions about the services and to be able to explain the rationale internally to client contact personnel and externally to the prospect and client. A clear pricing strategy not only sets the pace for the group but facilitates selling trust services. For example, should you be a price leader or follower? Unbundled or bundled? Component priced (e.g.: using each component of the services processing, investment management and fiduciary management as a building block scheme to distinguish the services)? Muti-fee'd (Administrative base fee, market value fee and/or income fee)? Relationship Priced? Once finished defining the organization's strategy, the structures should be designed to achieve the profit goals balanced by the need to remain competitive. For example, if you want to surpass the 1 percent threshold, is it better to use basis points on administrative fee or an income fee? It is important to determine what message you want your strategy and structures to send. Minimum fees send the message of the account size you wish to attract. Again, I remind you of the message sent by discounting common funds. Trust should never discount fees. They may provide "preferred pricing," but never discounts.

When considering the competition in pricing decisions, most trust organizations compare fees only with other trust organizations and not with non-trust providers of similar services. The responses to the BEI Golembe survey indicated that while 98 percent of personal trust organizations surveyed compared fees with other trust organizations, only 12 percent compared their fees with brokers, 4 percent with insurance companies, and 17 percent with CPAs, attorneys and mutual funds. Trust organizations compete with a wide variety of competitors including brokers, investment managers, insurance companies, mutual funds, attorneys, accountants and more. Both the technical pricing methods and the approach to presenting and disclosing fees vary widely among these competitors making an "apples to apples" comparison difficult.

As a whole, services offered by the trust industry are vastly underpriced compared to fees charged by non-trust competitors for the same level of service. For example, on a $500,000 Investment Management Account, using model portfolio assumptions about the investments and trade activity, the nationwide average trust fee is $4,410, a broker would generate commissions of approximately $7,200, the broker wrap fee would be $15,000, an investment manager would charge $5,500, an investment manager in conjunction with a custodian would cost $7,365 and a mutual fund would have an average fee (if spreading the load fee over five years) of $9,400. And yet these same competitors have, as we have seen, made signif-

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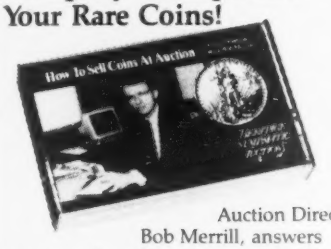

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icant inroads into our markets. Their ability to "mask" fees has been our competitive disadvantage. This is an area where industry-wide advertising could enhance our competitive position by disclosing fees and fee tactics of non-bank competitors. The value of the services provided must be recognized by the trust organization itself before its clients can be expected to recognize it. Understanding the value of trust services comes from a deliberate and careful review of the services and pricing of other providers.

A significant number of trust departments still do not incorporate risk in their pricing structures. While our research found that cost was considered to be the most important factor in establishing price, cost is not related to value. Value is a market-driven measure of what price should be. The only role cost should play in that process is to determine the floor below which price should not fall.

Pricing should not be looked at as a one-time isolated event. It should be taken on as an ongoing, well-defined process that starts with overall goals for the organization from senior management, then pulls from the various elements such as cost, competition, value and risk to best represent and execute the goals. Structures should then be developed to best capture the overall strategy and style. Fee levels should be determined and actual pricing practice should execute the overall strategy, style, structure and content. Many organizations will develop an overall strategy and lose out on it in its application with waivers, reversals, discounts and exceptions.

How the accounts are actually priced is a very important element in the process. Additionally, it is important to note that this is an ongoing process. As the goals of the organization change, the strategy will change as will the structures, etc.

Understanding of the process by those who are responsible for explaining pricing to the client is a crucial element in success. Understanding the magnitude of pricing adjustments that are warranted is the only way the adjustments will be accomplished. Education, training and communication are all necessary elements to accomplish the process. Appropriate pricing is crucial to ensure the continued and future delivery of superior services. While pricing adjustments are typically viewed as painful, they should be viewed as a proactive method to "resell" the customer by reinforcing those benefits which we provide.

Trust Performance

One final method of marketing trust services, particularly internally, is to highlight the benefits of trust services to the parent/host through solid contributions to profits. We need to demonstrate to our parent/host that through the trust function they can count on performance. To do so, we need to develop and use performance measures that are directly relevant to the concerns of executive management or shareholders. Credible measures that demonstrate trust's actual and potential contributions to consolidated income and shareholder value need to be applied.

All "for profit" businesses have a common ultimate need: to maximize return to shareholders. In the trust industry, that translates into maximizing the value of the organization by increasing revenues, improving efficiency or by sale and reinvestment in more profitable lines of business.

Most trust organizations are affiliated with commercial banks. Because of pressures on traditional banking profits, the resulting focus on non-banking activities, the market expansion for trust and related securities activities and the expansion of securities powers, trust has the potential to become a more significant segment of the banking industry and the financial services sector on the 1990's. In fact, trust and related securities activities may represent the best hope for the banking industry's long-term profitability. To realize its potential, trust must demonstrate to the audiences that allocate resources and capital that this potential exists.

The special performance measurement challenge to bank-affiliated trust organizations is to demonstrate their current and potential contributions to their host organizations in order to win the internal competition for resources needed for growth in traditional and non-traditional trust and trust-related products and to maximize their contributions to the consolidated company.

The BEI Golembe nationwide survey of trust institutions asked a number of performance measurement related questions. In general, it found an industry that recognizes common measures for internal performance measurement. These measures are, for the most part, measures recommended by Cates and Coughlin. We also found significant differences in the usage of certain mea-

sures between large and small trust organizations, significant differences between the perceived importance of certain measures and usage of those measures and, most important, indications that many in the industry use measurement approaches for their host executive managers and shareholders that are directly relevant or that lack credibility with their intended audience.

The most commonly used measure of trust organizational performance is pre-tax profit margin. Our survey listed a number of performance ratios, asked which of them the respondents used, and which they thought would be important in the mid-term. Almost 90 percent of the respondents use profit margin measurement today, compared with only about 58 percent who measure performance based upon either pre-tax income or net income contributed to the parent company. If the primary goal of trust should be to maximize its income and return to its investors, then the industry is missing the mark. It is focusing on a secondary measure, when it should be focusing on income contribution.

The average pre-tax profit margins by product line reported in our survey are shown in Figure 3. Note the extreme differences among products. If the relationships of these profit margins are reasonably accurate, business mix should have a great deal to do with overall trust profit margins.

Figure 4 shows survey reponses to the question, "What is an acceptable profit margin for a high-performance trust organization?" The averages for respondents above and below the survey me-

FIGURE 3
Pre-Tax Profit Margins By Product Line

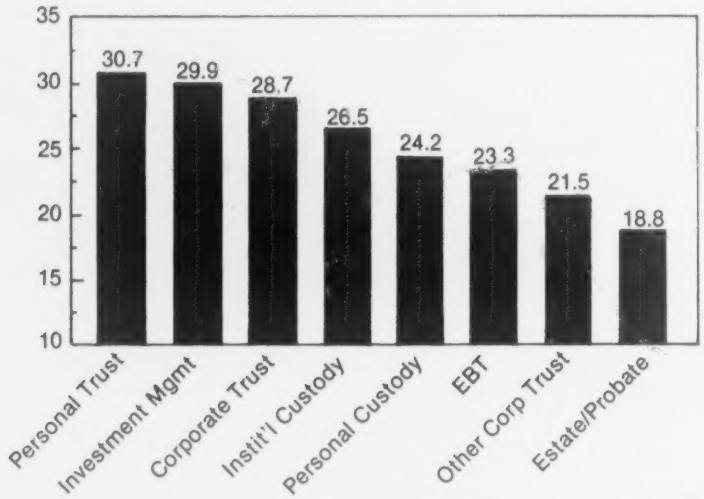
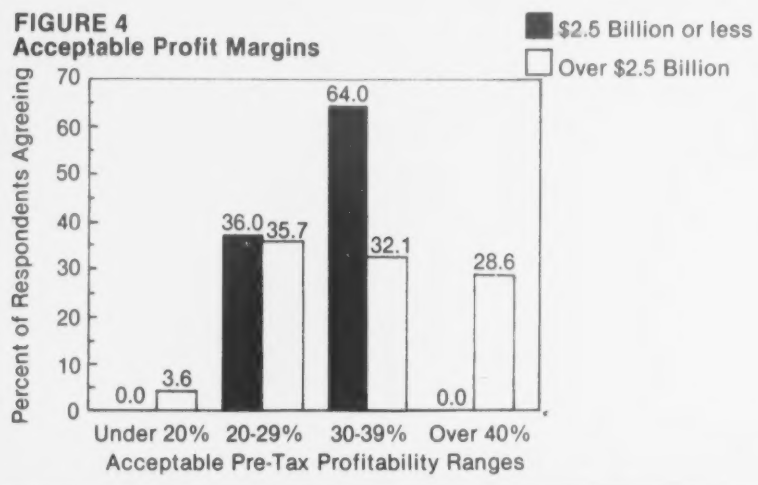


FIGURE 4
Acceptable Profit Margins



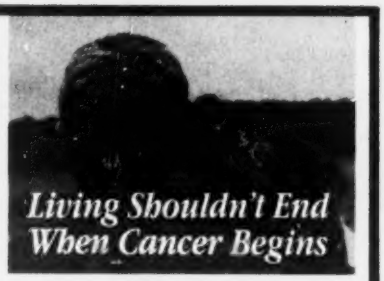


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TABLE 1

Product Profitability Ratios

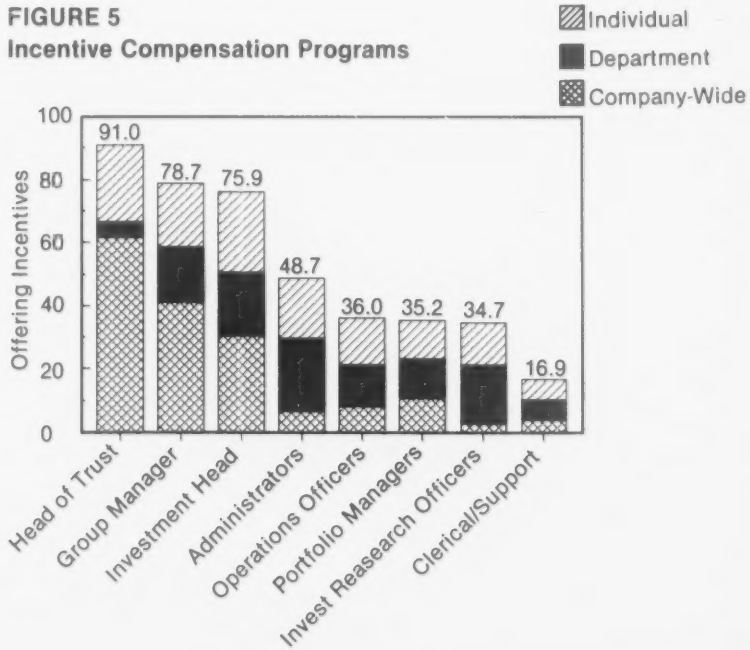
	Use Today	Future Importance: Important	Future Importance: Not Important
Fee growth	77%	100%	0%
Expense growth	69	100	0
Profit margin	65	100	0
Product "income" to total trust "income"	60	92	8
Average account size	59	98	3
Asset growth	54	91	9
Fees to assets	33	82	18

TABLE 2

Personnel Productivity Ratios

	Use Today	Future Importance: Important	Future Importance: Not Important
Administrative account load	79%	92%	4%
New fee business per business development officer	69	100	0
Portfolio manager account load	60	87	13
Gross income per employee	59	96	4
Fee income per administrative officer	59	46	54
Net income per employee	56	100	0
Accounts opened per business development officer	39	70	30
Operations staff as a percentage of total staff	32	79	21

FIGURE 5
Incentive Compensation Programs



dian for assets administered ($2.5 billion) are shown separately. There was substantial disagreement between and among smaller and larger organizations.

Survey respondents chose profit margins as the best measure of comparison for both other business segments of the banking organization and other trust organizations. Profit contributions, however, also were considered very important in making these comparisons. While only about 58 percent of respondents actually used some measure of their contribution to their parent or host organization, almost 75 percent said that profit contributions should be used in making comparisons with other trust organizations. In response to another question, slightly more than 50 percent of respondents favored measuring trust performance by its relative contribution to the banking organization's earnings per share.

Trust organizations perform extremely well on average against internal competitors in those measures that should mean most to shareholders and executive managment, net income contribution, shareholder value contribution and return on investment. Those are the relevant measures for them and the industry. The trust industry should abandon its emphasis on pre-tax profit margins.

A majority of survey respondents measure product profitability in some way. An overwhelming majority believes that product profitability measures should be used. The only caveat is that organizations should balance the need for detail and frequency of product profitability information with the cost of maintaining an accurate system of measuring it. See Table 1.

Most survey respondents use some standard measure of personnel productivity, as shown in Table 2.

Over the last decade, the trust industry has begun to use incentive compensation programs and standard personnel performance measures. Research was conducted on trust and other industries in order to assess the use of incentive compensation and performance measures in the industry and to explore alternative approaches that may be useful for trust in the 1990's.

The 1989 BEI Golembe Trust Survey revealed that an overwhelming majority of trust organizations make use of incentive compensation programs, as illustrated in Figure 5.

As expected, incentive programs of-

(Continued on page 60)

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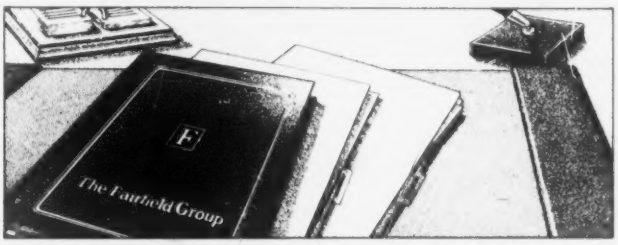

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MILLER

(From page 55)

in an area of intense exploration activity, particularly one where high volume production has already been found, and where the mineral interest is not already under lease.

Non-producing mineral interests in areas which have attracted little interest in the past, or where the geological data suggest little likelihood that commercial production will ever be established, will be valued at a very low multiple of whatever bonuses are currently being paid.

While there is great uncertainty connected with whether any particular mineral interest is going to generate revenue from bonus or delay rental payments, it is even more uncertain that any royalty income will ever be generated. Most new oil and gas leases are never drilled, and the majority of those that are drilled result in dry holes. Except for special situations, as where the tract in question is virtually surrounded by producing wells and the drilling of a well on your tract is imminent, it is just not very likely that production is going to be established.

That being the case, it normally is not appropriate to assign more than a nominal value to non-producing oil and gas interests as a result of their capacity to generate royalty income.

Summary

In summary, the fair market value of an oil and gas interest is a function of its anticipated capacity to produce cash flow. For producing properties too small to justify a detailed engineering study and for non-producing properties, detailed information must be developed in order to select an appropriate multiple of production or bonus income to estimate fair market value. The appropriate multiple will, in almost every case, be significantly lower than a multiple of earnings appropriate to securities or surface interests in real estate. □

Mary Miller is vice president of BEI Golembe, a financial consultant firm based in Atlanta. She recieved her J.D. at Capital University in Columbus, OH, and her B.A. at Clairmont Colleges in Clairmont CA. She is a member of the Georgia Bar Association and the Ohio Bar Association.

CASTLETON

(From page 32)

fered by respondents are more often available for higher positions in the organization. Most respondents (91 percent) indicate that they offer incentive compensation to the head of the trust organization, but the majority of institutions do not offer incentives for operations officers, investment research officers or support staff. As a consequence of greater competition for employees and greater specialization of functions, larger organizations are more likely to offer performance-based incentives to each category of staff.

In summary, everything we do creates and projects an image. We, as an industry, have the necessary components to emerge in the 1990's as leaders and capture the marketplace. However, we must educate our peers and our prospects. Maybe this begins with educating, or re-educating, ourselves. □

John Castleton is an independent oil and gas producer and consultant in Houston, Texas. He received his B.B.A. and J.D. degrees from The University of Texas at Austin.

Advertising Index

ASPCA 54
Banccorp Systems 46
Cannon Financial Institute 17, 25
Continental Bank 19
Virginia Cuyler 50
Dyatron Corporation CV3
Equity Resources 60
Fairfield Group 55
Federated Investors Inc. 11
Fidelity Investments 7
Franklin Distributors 13
Geneva College 45
Global Tracing Services 45
Hadley School For The Blind 58
Health Force 22
Heart Disease Research Foundation 26
Heritage Numismatic 50
Husted Burrell Company 24
International Genealogical Search 39
Jewish Guild For The Blind 24
Leland, Inc. 26
Leukemia Society of America 47
Lighthouse 16
McKay Hochman, Inc. 43
Medical Personnel Pool 21
Memorial Sloan-Kettering 27
Millennium Guild 28
Muscular Dystrophy Association 48
National Cancer Foundation 53
New England Villages 53
North Shore Animal League 28
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